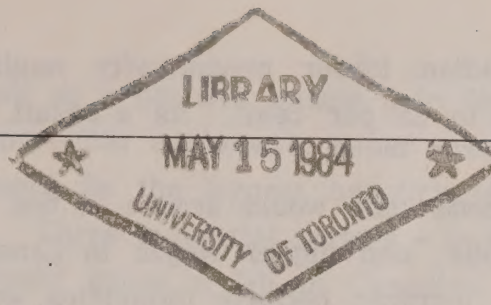




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TORONTO ... Free trade would yield substantial benefits for the Canadian economy. That's the message given by a research study prepared for the Ontario Economic Council. It says trade liberalization would produce substantial overall economic benefits for Canada by boosting the manufacturing sector, and in turn, provide economic gains for Canadians in general.

The study, Trade, Industrial Policy, and Canadian Manufacturing was written by Richard G. Harris, Professor of Economics, Queen's University, with the assistance of David Cox, Economics Professor, University of Western Ontario.

They created a model of the economy to find out what would happen to the manufacturing sector in Canada if we were to move to a position of free trade with either the rest of the world or with the United States. Their results were quite startling, because they found free trade would substantially enhance the manufacturing sector, and the Canadian economy as a whole would benefit substantially.

The average Canadian would be better off

'The gain in Canadian real income to free trade from the initial 1976 levels of protection would be on the order of 8 to 10 per cent of

This report reflects the views of the author and not necessarily those of the Ontario Economic Council. The Council establishes policy questions to be investigated and commissions research projects, but it does not influence the conclusions or recommendations of authors. The decision to sponsor publication of this study was based on its competence and relevance to public policy and was made with the advice of anonymous referees expert in the area.

GNP.' Canadian labour productivity would record gains on the order of 20 to 25 per cent. As a result real income would rise.

The real income gain would accrue in two forms; lower prices for imported goods, and higher wages to Canadian workers. Productivity would increase because industries would be able to expand output and substantially reduce their costs.

This study suggests that some groups will win, some will lose, but the winners will outnumber the losers. Under a multilateral free-trade agreement, some highly protected industries such as clothing, textiles and footwear would fare quite poorly. Alternatively, other manufacturing sectors would do very well. The transportation equipment sector, for example, would do well in any move toward freer trade.

What Harris and Cox have done is to reassess the evidence on the costs of protection for Canada by including imperfect competition and economies of scale within a general equilibrium analysis. These assumptions have long been recognized as important but have not yet been included in general equilibrium models due to various difficulties. The unique approach taken by the Harris and Cox model provides for firms to gain a per unit cost advantage as output is expanded.

What is perhaps surprising is the impact the departure from the traditional analysis has on the results obtained. The empirical results suggest that the costs of protection are much higher than suggested by most authors. Second, and perhaps even more important, the predictions as to the pattern of resource allocation induced by protection are quite different from those suggested by the traditional models which economists use.

Harris and Cox also examine the issue of sectoral free trade. In a series of free trade experiments they compute the gains or losses to Canada of our negotiating free trade arrangements in each of 20 manufacturing sectors. Their model suggests sectoral free trade arrangements would generate increased employment opportunities in

that sector as well as a positive income gain for 12 of the industries. The transportation equipment, paper products, and primary metals sectors would be the largest beneficiaries of sectoral free trade agreements. Three industrial sectors - leather, clothing, and knitting mills - would cause a fall in Canadian income if sectoral free trade agreements were adopted.

This study undertakes to examine some aspects of the role of industrial policy in the determination of a nation's economic welfare and economic structure.

Professors Harris and Cox point out that the interaction between trade and industrial policy cannot be emphasized enough. They conclude that industrial policies are a poor substitute for free trade, and that industrial policy by any level of government constitutes interference in the international marketplace. However, in light of the interest shown in developing industrial policies, Harris and Cox use their model to determine the effect and usefulness of several commonly discussed industrial policies.

- Employment subsidies. The study calls for careful use of wage subsidies in export industries since they may violate GATT conventions regarding subsidies. Employment subsidies are, however, the most effective policies at generating employment. They are particularly effective in protecting employment in the labour intensive, import-sensitive industries.

- Capital subsidies. Harris and Cox say 'it would be difficult to find a policy with so few redeeming features'. The effects on Canadian real income are negative on every industry examined. In addition capital subsidies generally cause employment declines within an industry and significant deterioration in labour productivity. The major effect of these subsidies is to encourage entry of new firms which diminishes the market share of all other firms.

- Import substitution policies. In general these policies do not have many desirable effects. Very often they actually shrink output and employment within an industry, contrary to conventional

wisdom. The income effects are usually negative and large relative to industry output. As an employment policy, import substitution appears to be far inferior to wage subsidies.

The other purpose of import substitution policies is to improve an industry's trade balance. The concern with sectoral trade balance often seems far out of line with its importance; nevertheless, it is often cited as a 'problem'. However, the results suggest that this belief is not well founded. For many industries the deterioration in the cost position of the industry through the effect on scale economies of increased protection can lead to an increase in imports over exports. This effect is particularly pronounced in the clothing and knitting mills industries.

- Export subsidies. The most dramatic effect an export subsidy policy has is to increase exports and improve the industry's trade balance. This is true for each industry. It also has significant employment effectiveness, although not as great as direct wage subsidies do. For most cases though, the aggregate income effects of the policy are negative, with some noted exceptions - namely the clothing, primary metals, metal fabricating, machinery and transportation equipment sectors.

- Industrial rationalization. The study says that in industries in which there are thought to be significant benefits to rationalizing the industry, a superior instrument is the removal of domestic protection. 'The simulation results on these types of policies suggest that they can lead to welfare improvements through forced rationalization of the industry. In all cases they have the effect of lowering average costs of production through increased production runs.' Selective tariff cuts are generally a superior instrument by which to achieve the same ends. Cutting protection promotes industry rationalization, yields benefits to consumers in the form of lower prices, and encourages exports.

Conclusion

'Canada is a nation with its economic future tied to the development

of a vigorous world trading system. It is a small open economy with a significant resource base and a manufacturing sector under considerable competitive pressure from abroad. Will the manufacturing sector disappear? The results of this study support the hypothesis that Canada's comparative advantage is not entirely geared toward natural resource extraction and processing. Under free trade, Canada would have a vigorous manufacturing sector with a significant export profile. The major effect of free trade would be higher real incomes for Canadian labour and lower prices for many imported and domestically produced goods.

The key to coming to this alternative view of resource allocation in the Canadian economy is the recognition of the importance of scale economies and imperfect competition within the manufacturing sector of a small open economy.

Much of this study has been devoted to explaining this alternative paradigm and its empirical implications for Canada. It is safe to predict that, in future years, analysis of economic policy in Canada in relation to productivity, trade, and industry will be profoundly affected by this alternative view. Much remains to be done.'

The authors wish to qualify their findings by pointing out that the policy simulations were done on a data set reflecting the structure of the Canadian economy in the mid-1970s. There have been some obvious changes in the economy and in external circumstances since that period which render some of the detailed industry results suspect. Nevertheless, the overall picture would seem to remain intact.

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Trade, Industrial Policy, and Canadian Manufacturing, 332 pages, price \$9.00, is available at the following outlets:

The Ontario Government Bookstore, 880 Bay Street, Toronto, to those shopping in person. Out-of-town customers may write: Publications Section, Fifth Floor, 880 Bay Street, Toronto, Ontario, M7A 1N8, or telephone 965-6015 (toll-free long distance, 1-800-268-7540; in northwestern Ontario, 0-Zenith 67200). A cheque or money order, payable to the Treasurer of Ontario, must accompany all mail orders.

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